

No. 29

November 13, 2001

H.R. 1552 – Internet Tax Nondiscrimination Act

Calendar No. 204

H.R. 1552 was read the second time and placed on the Senate Calendar on October 30, 2001. Because there was no committee referral, there is no committee report.

NOTEWORTHY

- At press time, no unanimous consent agreement had been reached for Senate consideration of H.R. 1552. However, on November 7, the Democratic Cloakroom hotlined a proposed unanimous consent agreement on H.R. 1552 and the proposed Enzi-Dorgan amendment [see Possible Amendments section for more details].
- The current moratorium on Internet taxes (as provided by the Internet Tax Freedom Act) expired on October 21, 2001. H.R. 1552, as passed by the House, would provide a two-year extension of the current moratorium, that is through November 1, 2003. The House unanimously passed H.R. 1552 under suspension of the rules on October 16.
- The Administration on October 16 issued a Statement of Administration Policy in support of quick action on the legislation, but noted its support for a longer extension: “While a five-year extension would be preferable, a two-year extension will provide additional time to analyze the impact of e-commerce on local and State tax receipts while urging that the growth of the Internet is not slowed by new taxes.”

HIGHLIGHTS

- The Internet Tax Nondiscrimination Act amends the Internet Tax Freedom Act to extend the moratorium on multiple or discriminatory State or local taxes on electronic commerce through November 1, 2003. It also maintains for two years the authority of States to collect Internet access taxes only if these taxes were generally imposed and collected before October 1, 1998.
- It is anticipated that at least one major amendment will be offered by Senators Enzi and Dorgan. On October 18, the two Senators introduced S. 1567, the “Internet Tax Moratorium and Equity Act.” S. 1567 provides a permanent extension of the moratorium on Internet access taxes and temporarily extends the moratorium on multiple and discriminatory taxes. The bill also: authorizes Interstates sales and use tax compact with Congressional review; authorizes Compact States to use either single, or blended use-tax rate for all remote sales; authorizes Compact States that become part of the system to require collection of use taxes. At press time, it was unclear to what degree that language might be modified as a floor amendment.

BACKGROUND

The report from the House Committee on the Judiciary provides the following background information:

The Scope of Electronic Commerce

The Internet and information technology (IT) industries comprise an increasingly vital component of U.S. economic health. According to the U.S. Department of Commerce, IT industries (which include the Internet) accounted for 35 percent of real U.S. economic growth in the year 2000. Internet retail sales continue to accelerate at an impressive rate. In the first quarter of 2001, e-commerce retail sales reached \$7.5 billion. While some forecasts estimate Internet retail sales might soon reach \$300 billion, these claims have yet to materialize. For example, during the first quarter of 2000, online retail sales represented less than 1 percent of overall retail sales. Moreover, recent weakness in the retail and technology sectors led to a decline in online retail sales during the second quarter of this year.

Taxing Status of the Internet

Contrary to the widespread impression that the Internet is a tax-free haven, electronic commercial transactions are subject to various State and local taxes. Telecommunications channels such as telephone lines, wireless transmissions, cable, and satellites are subject to taxation. Electronic merchants are required to pay State and local income, licensing, franchise, business activity, and other direct taxes. In addition, physically-present electronic merchants are required to collect and remit applicable sales and use taxes for all intrastate transactions. In short, online transactions

are subject to nearly all taxes imposed on traditional, brick and mortar enterprises. The only substantive difference between the tax treatment of online and traditional retailers is a State's authority to require nonresident electronic merchants to collect and remit sales and use taxes. While State and local governments have continually sought to expand their ability to tax nonresident businesses, constitutional limitations on State and local taxing authority have made it considerably more difficult for them to do so.

Constitutional Limitations On State Taxing Authority

While State and local governments may tax most transactions occurring within their taxing jurisdictions, this authority is not unlimited. More specifically, the Constitution has been interpreted to constrain State power to compel nonresident, remote sellers to collect and remit State sales and use taxes.

Dormant Commerce Clause

The Commerce Clause of the Constitution authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." While the Commerce Clause establishes a predicate for congressional commercial regulation, the Supreme Court has also interpreted the Commerce Clause to create a "negative" limitation on State power to regulate in areas that might adversely affect interstate commerce. This limitation on State power is referred as the "Dormant Commerce Clause." Because State and local taxes might unduly burden the course of interstate commerce, the Supreme Court has placed constitutional constraints on State and local taxing authority.

The fullest legal explanation of Dormant Commerce Clause limitations on State taxing authority is *Quill Corp. v. North Dakota*. Quill concerned North Dakota's attempt to require an out-of-State mail order catalog retailer to collect and pay a use tax on goods purchased for use within the State. Quill Corp., a Delaware corporation, grossed more than \$1 million a year in mail order catalog sales to North Dakota residents, but lacked physical presence in the State. When North Dakota moved to compel Quill Corp. to collect and remit use taxes, Quill claimed the tax was unconstitutional. The Supreme Court concluded North Dakota's efforts to compel a remote seller to collect and remit use taxes to that State without a physical presence or other "substantial [taxing] nexus" violated the Commerce Clause. By conditioning State authority to collect use taxes on a remote seller's physical presence in the taxing State, the Court maintained a previously enunciated use tax safe harbor for remote vendors "whose only connection with the customers in the taxing State is by common carrier or United States mail." While the Supreme Court has yet to specifically rule on the constitutionality of requiring nonresident, Internet merchants to collect and remit State and local use taxes, these enterprises are analogous to mail catalog companies to the extent they may lack a "substantial nexus" to justify the imposition of State and local taxes under the Commerce Clause. State and local efforts to require nonresident Internet retailer to collect and remit State use taxes would thus likely fail constitutional scrutiny.

Due Process Clause

The Fourteenth Amendment of the Constitution provides that no State shall “deprive any person of life, liberty, or property without due process of law.” This provision has been interpreted to limit the power of a State government to assert taxing jurisdiction over parties who do not reside in the forum State. A State statute imposing a tax on sales by out-of-State retailer will withstand Due Process challenge if the taxing State demonstrates “some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax.” As long as the taxpayer “purposefully avails itself of the benefits of an economic market in the forum State, it may be subject to that State jurisdiction even if it has no physical presence in the State.”

The Supreme Court has yet to rule on the degree of connection a nonresident electronic merchant must have with a taxing State in order to satisfy the Due Process “minimum contacts” test. It is likely a nonresident retailer that seeks to sell merchandise through advertisement or other solicitation will be considered to have “purposefully availed” itself of the benefits of the taxing State’s market for purposes of meeting the Due Process requirement set out in Quill. However, meeting this requirement would not necessarily validate the constitutionality of the tax since a corporation “may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause and still lack the ‘substantial nexus’ required by the Commerce Clause.”

State and Local Efforts to Tax Electronic Commerce

Sales and use taxes comprise a substantial portion of State tax revenues. Last year, State and local governments collected \$181 billion in sales and use taxes, accounting for 25 percent of all state government revenue. Based on an estimated \$25 billion in Internet retail sales in 2000, States claim to have lost an estimated \$950 million in unpaid sales and use taxes.

To stanch perceived future tax revenue losses, some State have begun to consider novel theories for expanding their taxing authority over online sellers. Some State taxing officials have speculated that an Internet service provider (ISP), which connects consumers to the Internet, acts as an agent of online seller and therefore creates “nexus” for electronic merchants “doing business” in the taxing State. The potential exposure of electronic merchants to a myriad of State and local taxing jurisdictions threatens the development and commercial viability of this increasingly important commercial medium.

ADMINISTRATION POSITION

On October 16, prior to House passage of H.R. 1552, the Administration issued the following Statement of Administration Policy (SAP):

**H.R. 1552 - Internet Tax Nondiscrimination Act
(Rep. Cox (R) California and 17 cosponsors)**

The Administration supports passage of H.R. 1552, the Internet Tax Nondiscrimination Act. The Administration believes that government should be promoting Internet usage and availability, not discouraging it with access taxes and discriminatory taxes.

As amended, H.R. 1552 extends the Internet tax moratorium enacted by the Internet Tax Freedom Act for two years. While a five-year extension would be preferable, a two-year extension will provide additional time to analyze the impact of e-commerce on local and State tax receipts while ensuring that the growth of the Internet is not slowed by new taxes.

The Administration encourages the Congress to act expeditiously to send to the President's desk legislation extending the moratorium before it expires on October 21, 2001.

[<http://www.whitehouse.gov/omb/legislative/sap/107-1/HR1552-h.html>]

COST

The House Judiciary Committee included in its report (H. Rept. 107-240) the following Congressional Budget Office (CBO) Cost Estimate:

CBO estimates that enacting H.R. 1552 would have no impact on the Federal budget. Because the bill would not affect direct spending or receipts, pay-as-you-go procedures would not apply.

By extending the prohibition on collecting certain types of state and local taxes, H.R. 1552 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA). The bill, however, would allow States that are currently collecting a sales tax on Internet access to continue doing so. Based on information from the Multistate Tax Commission and the Federation of Tax Administrators, CBO believes enacting this bill would not affect state and local revenues currently being collected. Thus, CBO estimates that the cost of complying with the mandate would not be significant and would not exceed the threshold established in the act (\$56 million in 2001, adjusted annually for inflation). The bill contains no private-sector mandates as defined in UMRA.

OTHER VIEWS

The Executive Committee of the National Governors Association issued the following policy position:

EC-12. Streamlining State Sales Tax Systems Policy

12.1 Preamble

The National Governors Association supports State efforts to pursue, through negotiations, the courts, and federal legislation, provisions that would require large out-of-state mail order firms to collect sales and use taxes from their customers. Such action is necessary to restore fairness to competition between local retail store purchases and out-of-state mail transactions and to provide a means for the states to collect taxes that are owed under existing law. The recent rapid growth of the Internet has underscored the importance of this equitable treatment. The Governors have called for the development of a twenty-first century sales tax that can achieve this fairness for all forms of sales: Main Street, mail order, and Internet. A streamlined sales tax with simplified compliance requirements will ensure that States are prepared to support the global electronic marketplace of the new century.

The U.S. Supreme Court in the Quill decision explicitly reaffirmed the authority of Congress to address state tax issues that affect interstate commerce. Although state action is needed to simplify the sales tax, federal action will be needed to ensure that it can be fairly applied.

12.2 Streamlined Sales Tax

The Governors call for joint industry/government development of a simplified sales tax system, including greater consistency among States in definitions, forms, and rules, and significantly easier compliance, reporting, and audit requirements. The Governors support the work of the National Tax Association's Communications and Electronic Commerce Taxation Project, the Northwest Regional Sales Tax Pilot Project, and other joint efforts. Sales tax simplification should conform to the following principles.

12.2.1 One Sales Tax Rate per State.

States will continue to have the option of not imposing the sales tax. In States where a sales tax is levied, each state will need to establish a single rate for remote sellers to collect. States will also need to establish a method of distributing to local governments their appropriate share of such taxes.

12.2.2 Uniform Structure and Simplified Compliance with the Sales Taxes.

The Governors call for joint industry/government development of a system in which the definitions of the goods or services that may be taxed are uniform and consistent across state lines. States will be allowed to choose whether or not to tax specific goods or services that are uniformly defined across all States. Besides simplifying the tax, these definitions will give States the ability to identify and address instances where discriminatory or multiple taxation currently exists. The Governors also call for joint industry/government development of significant simplifications in the administration of the sales tax in areas such as uniform registration, tax returns, remittance requirements, and filing procedures.

One potential approach to administration of sales taxes would be to encourage establishment of a system of independent third-party organizations that would be responsible for remitting taxes to the States. Remote sellers would use a software package preapproved by the States that would calculate the tax due on the purchase based on the state rate where the item is sent, and electronically remit that tax to the collection organization. Remote sellers that opt to use the third-party system would enjoy additional benefits of compliance, including not filing returns and not remitting funds to States.

12.3 Expanded Duty to Collect.

The Governors call on Congress to re-establish fairness in State sales tax systems by requiring remote sellers to collect sales taxes for any State that simplifies its tax system in accordance with the foregoing principles. States that choose not to simplify the sales tax would retain a narrow and limited physical nexus standard. The expanded duty to

collect would require remote vendors to collect sales and use tax in every State where they sold taxable products and services only if:

- they had national sales above some de minimis level in the past year; and
- they had sales to that individual State's consumers above some lower de minimis level in the past year.

It is the Governors' intention that small companies (for example with annual gross sales below \$100,000 or \$200,000) should not be required to collect State sales taxes on out-of-State sales except under the proposed independent third-party administration system described above. Even in that instance, there should be no charge to such small companies.

Time limited (effective Winter Meeting 2001 - Winter Meeting 2003).
Adopted Winter Meeting 1999; reaffirmed Winter Meeting 2001.

POSSIBLE AMENDMENTS

At press time, it was the understanding of the Republican Policy Committee that Senators Enzi and Dorgan will offer an amendment similar to S. 1567, the "Internet Tax Moratorium and Equity Act." S. 1567 contains the following provisions:

Extension of Internet Tax Moratorium

S. 1567 provides a permanent extension of the moratorium on Internet access taxes, and extends the moratorium on multiple and discriminatory taxes for five years.

Streamlined Sales and Use Tax System

S. 1567 provides that it is the sense of Congress that States and localities should work together to develop a streamlined sales and use tax system that addresses the following in regards to remote sales:

- a centralized, multi-state reporting, submission, and payment system for sellers;
- uniform definitions for goods and services sold;
- uniform rules for attributing transactions to particular taxing jurisdictions;
- uniform procedures for treatment of purchasers exempt from sales and use taxes; and relief from liability for sellers that rely on such State procedures;

- uniform software certification procedures;
- uniform format for tax returns and remittance forms;
- consistent electronic filing and remittance methods;
- State administration of all State and local sales and use taxes;
- uniform audit procedures, including a single audit at the seller's election;
- reasonable compensation for sellers to cover collection costs; and
- exemption from use tax collection requirements for remote sellers with less than \$5 million in gross annual sales.

Interstates Sales and Use Tax Compact and Congressional Review of Simplified Systems

The legislation provides authorization that once 20 States have developed and adopted an Interstate Simplified Sales and Use Tax Compact, the States will submit the Compact to Congress. Once the Compact is submitted, Congress will have 120 days to consider the plan under fast-track procedures. Congress will vote up or down on whether those 20 States have adopted simplified systems that do not create an undue burden on interstate commerce. If Congress approves the Compact, States that are signatories to the Compact will be authorized to compel remote sellers to collect sales and use taxes.

Authorization to Simplify State Use-Tax Rates Through Averaging

The legislation allows Compact States to use either a single, blended use-tax rate for all remote sales, or States could require the collection of the actual State and local sales or use tax due on each sale if the States provide sellers with the information to identify the applicable State and local sales or use tax.

Authorization to Require Collection of Use Taxes

The legislation provides a grant of authority to States that adopt the system may require collection. Any State that has adopted the system described in the Compact is authorized to require all sellers not qualifying for the de minimis exception to collect and remit sales and use taxes on remote sales to purchasers located in such State. States that do not adopt the system may not require collection.

Nexus

Changes to sales and use tax collection duties in S. 1567 would have no bearing on whether a seller has nexus for any other state or local tax, including franchise and income taxes.

Nexus for State Business Activity Taxes

It is the Sense of Congress that legislation should be enacted to determine appropriate standards for determining whether nexus exists for State business activity tax purposes before the end of the 107th Congress.

Statement by Senator Enzi

These excerpts from the October 11, 2001 Congressional Record are in reference to an earlier version of S. 1567.

With the extension of the current moratorium of the Internet Tax Freedom Act of 1998 expiring soon on October 21, 2001, there are several bills that are currently being discussed in the Senate in order to address this issue. I had to take a look at the Internet sales tax issue for people who might be using legislative vehicles to develop huge loopholes in our current system. We are federally mandating States into a sales tax exemption. We need to preserve the system for those cities, towns, counties, and States that rely on the ability to collect the sales tax they are currently getting. I believe that the current moratorium on Internet access taxes and multiple and discriminatory taxes on the Internet should not be extended without addressing the larger issue of sales and use tax collection on electronic commerce. . . .

Certainly, no Senator wants to take steps that will unreasonably burden the development and growth of the Internet. At the same time, we must also be sensitive to issues of basic competitive fairness and the negative effect our action or inaction can have on brick-and-mortar retailers, a critical economic sector and employment force in all American society, especially in rural States like Wyoming. In addition, we must consider the legitimate need of State and local governments to have the flexibility they need to generate resources to adequately fund their programs and operations. . . .

I understand the importance of protecting and promoting the growth of Internet commerce because of its potential economic benefits. It is a valuable resource because it provides access on demand. In addition, it is estimated that the growth of online businesses will create millions of new jobs nationwide in the coming years. Therefore, I do not support a tax on the use of Internet itself.

I do, however, have concerns about using the Internet as a sales tax loophole. Sales taxes go directly to State and local governments and I am very leery of any Federal legislation that bypasses their traditional ability to raise revenue to perform needed services such as school funding, road repair, and law enforcement. I will not force States into a huge new exemption. . . .

Throughout the past several years, we have heard that catalog and Internet companies say they are willing to allow and collect sales tax on interstate sales, regardless of traditional or Internet sales, if States will simplify collections to one rate per State sent to one location in that State. I think that is a reasonable request. I have heard the argument that computers make it possible to handle several thousand tax entities, but from an auditing standpoint as well as simplicity for small business, I

support one rate per State. . . .Therefore, the bill would put Congress on record as urging States and localities to develop a streamlined sales and use tax system, which would include a single, blended tax rate with which all remote sellers can comply. You need to be aware that States are prohibited from gaining benefit from the authority extended in the bill to require sellers to collect and remit sales and use taxes on remote sales if the States have not adopted the simplified sales and use tax system. . . .

I recognize this body has a constitutional responsibility to regulate interstate commerce. Furthermore, I understand the desire of several senators to protect and promote the growth of Internet commerce. Internet commerce is an exciting field. It has a lot of growth potential. The new business will continue to create millions of new jobs in the coming years. . . .

I am very concerned, however, with any piece of legislation that mandates or restricts State and local governments' ability to meet the needs of its citizens. This has the potential to provide electronic loopholes that will take away all of their revenue. . . .

The States, and not the Federal Government, should have the right to impose, or not to impose, consumption taxes as they see fit. The reality is that emergency response personnel, law enforcement officials, and other essential services are funded largely by States and local governments, especially through sales taxes. Passing an extension of the current moratorium without taking steps toward a comprehensive solution would leave many States and local communities unable to fund their services.

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